ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

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US Commentary

By Mark Zavanelli

Trade and economic concerns came roaring back in May and stock prices responded accordingly. This was quite a reversal from where things stood just a month ago. At that point, with trade issues on their way to resolution and the Fed tightening cycle over, it looked like the market could continue its strong rally from the lows last December. But not so fast. The market had priced in a trade deal with China, which didn't happen. At the last minute the Chinese decided to water down the parts of the deal they liked the least (having to do with codifying changes to their mercantilist policies into Chinese law). Unfortunately, this doesn't seem to have been a normal negotiating back and forth, but instead a calculation that they will have their way by inflicting enough damage on Trump that he either fails to get re-elected or is forced into a more favorable deal by a weak stock market and economy. This is a strategy that makes a near term resolution unlikely. Trump and Xi will meet this month and will try to put on a face of cooperation so they can sell a future deal, but the reality over the next several months will almost certainly be higher tariffs and tit-for-tat actions against specific companies. The best that can be hoped for

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Asian and UK Results

By Vaidas Petrauskas

The trade war was back on investors' minds in May. In April the market acted as if a trade deal between the U.S. and China was a done deal. Then we found out that China has backed off on many previously agreed concessions and the deal collapsed. President Trump gave China one month to agree to his terms. China is willing to sign a trade deal which lets them save face, one in which they don't appear to be totally capitulating, but I don't think the White House will meet them half way. We'll see. In June, there is a big G20 meeting in which President Trump and President Xi Jinping will meet. Some expect a trade deal to be announced then. I doubt it, but if it happens it will be a huge boon for stocks across the globe.

Meanwhile, trade negotiations between the U.S. and the EU have stalled. Another front in the trade war opened on May 30th when the White House imposed tariffs of up to 25% on Mexico over the migrant surge. The 5% tariff rate will go into effect on June 10 on all Mexican goods and will increase incrementally during the summer to reach 25% on October 1. The latest salvo from Trump shows that he is willing to use tariffs to solve any kind of problem, even non-trade related, like illegal immigration. He is indeed a Tariff Man. On June 3, President Trump removed zero-duty access for Indian companies. Previously it was Turkey. Both India and Turkey are part of the Generalized System of Preferences (GSP) – a US trade program designed to promote economic growth in the developing world by providing preferential duty-free entry for products from beneficiary countries.

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Trade Slowdown vs. A Friendly Fed

By Mark Zavanelli

Worldwide manufacturing was looking shaky even before the latest tariff actions. Final demand in the US for big ticket consumer items such as autos and housing has been slowing for the past year due to earlier interest rate hikes. Reported GDP looked good partially due to the extra inventories that were built over the last three quarters to insulate companies from tariff related costs and disruption. Now this will create a hangover as they are drawn down. Corporate capital spending is also slowing as a result of trade uncertainty and slowing profit growth. These areas of the economy have an outsized impact on reported growth because of their volatility, even though their importance to the overall economy has declined over time. The new tariffs will increase costs, regardless of which party bears them, and reduce demand. This is what happened to washing machines after the 2018 tariffs went into effect. Prices rose, and demand adjusted accordingly, with units sold falling even for Whirlpool, which had asked for the tariff in the first place. The economic reverberation from the combination of inventory reductions, new tariffs and the prior rate hikes is going to send US GDP growth close to zero as it winds its way through the economy.

However, there's an important offset. Credit is more important than trade. It affects consumer and corporate spending in a pervasive way. A friendly Fed may be more important than all of the trade issues. In a typical cycle, credit is the cause of an economic downturn as central banks increase the price and restrict the quantity of credit in order to short circuit booms and prevent inflation. We were on our way towards this but it has been disrupted. Until January we were well on our way towards a severe tightening cycle with interest rate hikes and Quantitative Tightening, trying to catch up from the excessive stimulus of prior years. It turned out that QT was actually having a powerful effect despite having a limited impact on bond prices. This can be seen in the growth rate of the money supply, which has been below the nominal rate of GDP. This was a classic credit tightening. It didn't help that the ECB was also rapidly halting their stimulus.

Just like the tax cuts and increased fiscal spending hurried the Fed into more aggressive tightening in 2017 and 2018, the trade fears short circuited the tightening cycle and are pushing the Fed towards easing. The combination was just too much for the market to take. Now, the Fed has stopped raising rates, is halting QT in September, and has hinted at openness to cutting rates. Interest rates that the Fed doesn't control are already falling. As I wrote a couple of months ago, it has been a sea change in the direction of rates, from an expectation of rising rates back to flat or falling. This is going to have a powerful economic impact. In a typical cycle the Fed cuts rates too late and credit supply is constrained due to poor credit quality. While we don't know what will happen this time, the unusual timing of this cycle may end up with the policy moves having essentially been accelerated, dampening the actual economic swings. It's important that the Fed not be fooled by temporary tariff related inflation and wait too long to begin cutting. The market may begin to react positively to weaker economic data if it perceives that the Fed is more likely to move. This may end up with a positive reset to the economic cycle, which would be very positive for stock prices.

US Commentary (Continued)

is the current status quo but even that seems unlikely. The Chinese have called Trump's bluff and now it's a game of chicken. The economic need to do a deal has morphed into a political battle. I think Trump's Mexican tariff threat is partially to show China that he likes tariffs and is more than happy to extend a 25% tariff to all Chinese imports. As for economic damage, Trump likely thinks the Fed will come to his rescue with rate cuts, which he wants anyway, and that the timing will work for him with a resolution by 2020. China is ready to let its currency slip to help offset the tariffs and is also confident in its ability to stimulate the local economy enough to prevent a severe downturn. Both sides dig in for economic warfare.

The bond market responded to these developments by moving back to an inverted yield curve and forecasting multiple Fed rate cuts this year. High yield bond spreads increased, but not by levels that would suggest a lot of worries about corporate defaults. Value stocks, which have been tightly linked to the changes in the yield curve over the past couple of years, were especially weak. I think the unusually tight sensitivity has been due to the idea that we're late in the economic cycle and that the earnings for value stocks will disappear in a downturn. In the market however, sometimes when things look especially bad it's actually a good sign. The bond market's forecast is all about predicting the Fed, and even during this episode of fear the yield curve is predicting a future steepening once the cuts begin to happen.

Between now and when the Fed cuts rates (maybe this fall) we will likely see continued volatility. We're no longer on the path to new market highs in the near term, but we should see bounces that could be significant. Although an economic slowdown has historically favored growth stocks on average, this cycle features a heavy dose of speculation which does not usually fare well once it breaks. I didn't expect this path for the market, but it actually solidifies the mechanism for a value resurgence down the road. Outright economic weakness followed by a return to growth is now more likely. Economically sensitive stocks in the US and trade sensitive foreign markets are very cheap on an absolute basis and relative to other stocks and asset classes. Earnings weakness is priced in, and this sets the stage for future outperformance when economic growth bottoms out and inflects positively. Operationally they will be fine in the coming slowdown. These companies have already seen many headwinds the last few years, unusual for a late cycle economy, so there is no boom to unwind.

Asian and UK Results (Continued)

President Trump clearly hates GSP and for good reason. No country is safe from new tariffs, especially if it has a trade surplus with the U.S.

All these new tariffs, which seem to come almost daily now, create a lot of uncertainty for global companies. Investment is delayed as a result. Exports plunge. New factories are not being built until it becomes clear what kind of tariffs will apply to any one country. The only safe country to build a factory in is the U.S. That is President Trump's ultimate goal – to return factories back home, even though the U.S.'s high wages put it at a disadvantage to some other countries.

If a trade war between the U.S. and China gets prolonged as I believe it will, production will definitely start moving out of China. But not necessarily to the U.S. The main beneficiaries of this expected relocation of factories are expected to be Southeast Asian countries like Vietnam and Thailand. Mexico could also be a big beneficiary, but the latest tariff announcement will make companies uneasy to relocate there. The relocation of production capacity from China has been happening for some time because wages in countries like Vietnam are lower. This process will now speed up.

At least relations with Japan are good and a trade deal with Japan in August is possible. The personal relationship between the Japanese Prime Minister Shinzo Abe and Donald Trump is very good. Trump visited Japan in May where he met the new emperor, played golf, watched sumo wrestling, and came back very satisfied by the progress of negotiations. Japan ordered 105 F-35 jets worth US$9.1bn which will close the trade deficit.

In May, all Asian companies reported quarterly results. Thai companies reported 1st quarter results. Japanese companies reported 4th quarter results and issued 2020 guidance. So stocks prices moved based on these reports and the general market sentiment which was negative.

We had another down month in Asia, which is very frustrating., But in light of the turmoil in the markets, our Asian stocks performed OK - in line with the overall

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Asian and UK Results (Continued)

market. I am disappointed by the Thai stock market. The Thai stock market should be cool-headed when global markets are in panic. But in May it experienced an unusual level of volatility. Stock prices reacted modestly to positive surprises but strongly to negative surprises. Hard to win when such a mood prevails in the markets.

That is not to say I didn't make mistakes. One IT company which we held for a long time and added along the way, unexpectedly reported a drop in earnings and the stock dropped 27%. The drop-off in demand which they experienced is temporary, but the market does not care. Earnings momentum is everything. We escaped a lot of the carnage but still lost over 5% in local currency in Thailand. Many stocks of Thai IT companies, which we do not own but are following, are back to levels seen in 2012. 7 years' worth of gains were erased in a few months. The adjustment was very quick and dramatic. I attribute the turmoil in Thai stocks to the U.S. – China trade war, as a result of which the growth of the Thai economy is clearly slowing because exports dropped (IT companies were especially hard hit), overall a negative May earnings season (many Thai companies reporting falling profitability on rising costs), and still uncertain political situation (the government is still not formed). As a result of all of the above, foreign funds have been flowing out of Thailand.

Our Japanese stocks are no longer blindly following the U.S. market moves – no longer falling after a big down day in the U.S. This is refreshing to see. I attribute this to the fact that there are few foreign institutional sellers left. The exodus from Japan started in January of 2018. Our performance was helped by a stronger Yen, which always strengthens during market sell-offs. The Yen strengthened over 2% against the US Dollar in May while our Japanese stocks lost over 5% in local currency. This was better than local indices. The main Nikkei 225 index closed down 7.45%.

We made many changes in Asian portfolios in May. We added 6 new Thai stocks to the portfolio. In Japan we sold cyclical industrial companies and switched the funds to some recession-proof businesses, like grocery chains. We quickly sold any stock where company's fundamentals are deteriorating or poor guidance was issued. We moved the funds to stocks where earnings are growing and guidance is good. We are only holding stocks of companies expected to grow strongly in the coming year with a few exceptions of deep value stocks.

This is already paying off. We managed to take profits in one Japanese grocery chain which we bought in the middle of May and it quickly rose 20% afterward. These types of Japanese businesses are liked by investors and are trading near 52-week highs, while most industrial companies trade closer to 52-week lows, even if they are growing and guidance is good. They are simply out of favor because of the trade situation and uncertainty surrounding global manufacturing.

There is a lot of excitement over improvements in stewardship and capital allocation in Japan. Buybacks announced in the first four months of the year are up 125% from a year ago. Even among our small capitalization Japanese stocks we feel the positive effects of this. One of our holdings announced they will repurchase 4.5% of their shares outstanding and the stock advanced 10% the following day.

The one negative I see for the Japanese economy specifically is the planned hike in sales tax from 8% to 10%. This should happen in October. Some believe the tax hike will be delayed again like before. But after the Japanese economy showed a growth of 2.1% in the first quarter (due to positive net exports and an increase in government spending), the sales tax increase will almost certainly go through. The Japanese government is preparing countermeasures, but those will not completely alleviate the negative effects of the tax hike.

I feel confident that our companies fundamentally will perform well in the coming year. But how their stocks will perform is impossible to say. Markets currently gyrate based on trade news and fears about a global recession caused in part by the trade war. At least one worry has been pushed away – we can forget about Fed rate hikes. More likely we will see a rate cut this year. How quickly things change. After a significant reshuffling of Thai and Japanese portfolios in May, we are almost fully invested and I am excited about our new additions to the portfolios.

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Just the Numbers

	Period Ending 5/30/19			Period Ending 3/31/19			
ZPR Composites Names in Bold *Benchmarks in italics*	Month	Quarter To Date	YTD	1 Year	3 Year Annualized	5 Year Annualized	10 Year Annualized
ZPR Fundamental Small Cap Value	-13.71%	-6.85%	2.38%	-18.19%	6.69%	4.42%	14.77%
Volume Winners	-3.10%	-0.50%	5.34%	0.52%	14.62%	12.09%	NA
Volume Value	-7.85%	-5.93%	4.59%	0.12%	18.48%	14.45%	NA
Volume Momentum	-7.96%	-6.91%	1.56%	-8.68%	10.50%	4.11%	NA
Russell 2000	-7.90%	-4.77%	9.12%	2.04%	12.92%	7.05%	15.36%
S&P 500	-6.58%	-2.79%	10.46%	9.49%	13.52%	10.92%	15.92%
ZPR Global Equity	-7.42%	-5.23%	2.23%	-19.68%	5.46%	2.87%	17.50%
MSCI ACWI	-5.85%	-2.62%	9.38%	3.18%	11.29%	7.04%	12.59%
ZPR All Asian	-3.58%	-3.90%	2.47%	-22.00%	4.59%	1.83%	20.34%
MSCI EAFE	-4.66%	-1.89%	8.05%	-3.21%	7.81%	2.81%	9.48%
ZPR All Thai Equity	-4.70%	-5.00%	0.13%	-14.54%	2.10%	4.63%	NA
Thai Set Index	-2.79%	-0.20%	5.58%	-4.78%	8.57%	6.98%	NA

Composite returns are presented net of management fees and trading expenses and include the reinvestment of dividends and other income. All returns are in US dollars except for the Thai Set Index, which is presented in Thai Baht.

Past performance does not guarantee future results. The table above reflects (1) performance of the ZPR Investment Management, Inc. ("ZPR"), composites named in bold in the first column, (2) performance of the benchmark which reflects the composite's investment mandate, objective, or strategy, and (3) performance of the S&P 500 Index, which is provided for overall comparison and informational purposes. Please see the reverse for important information about composite and benchmark descriptions, how to receive more complete information about the composites, and disclosures regarding the calculation of performance, among other matters. Subsequent markets may perform better or worse than for the periods shown, which will cause the actual results of a portfolio to be better or worse than shown. ZPR does not guarantee or offer any assurance that any portfolio or account will be profitable, meet a client's stated objectives, or prevent or reduce losses. **A client may lose money by investing in a portfolio.**

ZPR Investment Management, Inc. ("ZPR") is an SEC registered investment adviser managing separate accounts that are fully discretionary. SEC registration does not constitute an endorsement of the firm by the Commission nor does it indicate that the adviser has attained a particular level of skill or ability. ZPR claims compliance with the Global Investment Performance Standards (GIPS™). To receive a complete description of the policies and procedures for any composite, a list and description of all ZPR composites, and a presentation that complies with the GIPS standards, please contact us at 386-775-1177 or compliance@zprim.com.

All composites include fully discretionary, management fee-paying and, beginning on January 1, 2011, non-management fee-paying accounts, including those accounts no longer with the firm. The U.S. Dollar is the currency used to express performance, except for the Thai Set Index, for which performance is expressed in Thai Baht. Returns are presented net of management fees and include all trading expenses and the reinvestment of all income. Net of fee performance was calculated using actual management fees, except in the case of non-fee-paying accounts where model fees have been imputed. Actual advisory fees and transaction fees will vary depending on, among other things, the portfolio, account size, and activity. Fees are described in ZPR's ADV Part 2A.

The benchmark and other data provided was obtained from publicly available reports, including internally derived databases and other resources available to ZPR. ZPR believes such data to be reliable but does not audit, verify, or guarantee its accuracy or completeness. When comparing the performance results to a benchmark, clients should keep in mind that: 1) Indexes are unmanaged and unavailable for direct investment. 2) Benchmark returns include reinvestment of income, but do not reflect taxes, or investment advisory or other fees that would reduce performance. 3) Performance information of benchmark indexes is included for comparison purposes only.

Composite and Benchmark Descriptions:

The S&P 500 and Russell 2000 are market cap weighted indices of large company and small company US stocks, respectively.

The Fundamental Small Cap Value Composite consists of accounts that hold U.S. small cap stocks selected by using ZPR Fundamental Analysis. This analysis identifies undervalued companies using ZPR's GRAPES valuation model and also applies other selection criteria relating to a company's business prospects, management quality, and capital structure. The benchmark for the composite is the Russell 2000 Index, presented in U.S. Dollars. In the past the composite has displayed higher volatility than its benchmark.

The Volume Winners Composite consists of accounts that hold U.S. micro cap stocks selected by using ZPR Volume Winners Analysis. This analysis is a quantitative evaluation system incorporating volume, momentum and valuation measures. The benchmark for the composite is the Russell 2000 Index, presented in U.S. Dollars. In the past the composite has displayed lower sensitivity to market returns than its benchmark, which would cause it to underperform in a strongly rising market.

The Volume Value Composite consists of accounts that hold U.S. micro cap stocks selected by using ZPR Volume Value Analysis. This analysis is a quantitative evaluation system incorporating volume and valuation measures. The benchmark for the composite is the Russell 2000 Index, presented in U.S. Dollars.

The Volume Momentum Composite consists of accounts that hold U.S. micro cap stocks selected by using ZPR Volume Momentum Analysis. This analysis combines two quantitative evaluation techniques; ZPR's price and earnings momentum measure SuperMo, and ZPR's volume, momentum and value system Volume Winners. The benchmark for the composite is the Russell 2000 Index presented in U.S. Dollars.

The Global Equity Composite consists of accounts that hold both U.S. and International stocks selected by using ZPR Fundamental Analysis. This analysis identifies undervalued companies using ZPR's GRAPES valuation model and also applies other selection criteria relating to a company's business prospects, management quality, and capital structure. The benchmark for the composite is the MSCI All Country World (Gross) Index, presented in US Dollars. MSCI ACWI is a market capitalization weighted index comprised of equities from developed and emerging markets, including the US. The composite has historically held small cap stocks from a limited set of countries while the benchmark weighting is primarily composed of larger companies spread across many countries. This is likely to cause the composite to have greater volatility than its benchmark. The composite includes the performance of accounts that may occasionally use margin; however, the use of margin is not part of the overall strategy of the composite.

ZPR All Asian Composite consists of accounts that hold Asian stocks selected by using ZPR Fundamental Analysis. This analysis identifies undervalued companies using ZPR's GRAPES valuation model and also applies other selection criteria relating to a company's business prospects, management quality, and capital structure. The benchmark for the composite is the MSCI EAFE Index, which is comprised of equities from developed markets around the world, excluding the US and Canada. MSCI EAFE is presented in U.S. Dollars. The composite has historically held small cap stocks from a limited set of countries, including emerging markets, while the benchmark weighting is primarily composed of larger companies from developed countries. This is likely to cause the composite to have greater sensitivity to the returns of countries where it invests, and overall greater volatility than its benchmark.

The ZPR All Thai Equity Strategy consists of accounts that hold Thai stocks selected using ZPR's Fundamental Analysis. This analysis identifies undervalued companies using ZPR's GRAPES valuation model and also applies other selection criteria relating to a company's business prospects, management quality, and capital structure. The benchmark for the composite is the Thai Set (TRI) Index, a market capitalization weighted index of securities listed on the Stock Exchange of Thailand and presented in Thai Baht. The composite has historically held small cap stocks while the benchmark weighting is primarily composed of large companies. This is likely to cause the composite to have greater volatility than its benchmark.